

Insolvent Trusts

This briefing note covers the practicalities that Trustees have to consider when a trust is no longer able to satisfy its immediate financial obligations.

Overview

A trust does not have legal personality and therefore cannot technically be labelled ‘insolvent’ or as having creditors. However, the use of ‘insolvent’ and ‘creditors of a trust’ has become more common place in the context of trusts particularly in instances where liabilities exceed the liquid trust assets that the trustees have available to meet the immediate financial liabilities of the trust.

In general terms, trustees utilise trust assets to compensate trust creditors, as and when the debts arise. Trust assets can include a wide range of items such as shares, cash, a discretionary investment portfolio, real estate and highly valued art. When there are no longer any liquid assets to use to cover the trust’s debts then inevitably the trustees must consider disposing of fixed assets in order to satisfy the trust’s debts so as to avoid creditors seeking to commence legal action.

Potential conflicts

In the instance of insolvency, trustees can be faced with various conflicts and obstacles. As examples:

- The trustees may be trust creditors too, as they are entitled to remuneration for their services;
- There will most likely need to be some balancing of potentially conflicting interests from multiple parties such as creditors, beneficiaries, protectors and the settlor;
- In the case of the settlor, he may have specified in a letter of wishes (or in the trust instrument) that certain trust assets are not to be sold. Of course, when trust assets are no longer liquid, and creditors are requesting payment then trustees may be forced to consider selling such valuable and cherished assets in order to settle the outstanding debts; and
- With regard to the trust instrument, the trustees should always check the document to ensure that there are no restrictions and they have the unambiguous powers they require in order to deal with the trust fund and creditors, as they think best.

Recent case law

A recent case in Jersey involved eight trusts (referred to as the “Z-Trusts”), which were all settled by one individual. Two of the Z Trusts were considered insolvent whilst the remaining trusts were in some financial difficulty. The matter was made more complex by the settlor and her family being creditors of certain trusts, complicated inter trust arrangements and four professional trustee companies being represented either as present or former trustees. One of the trustees applied to the Royal Court of Jersey for directions, which established two important principles when dealing with an insolvent trust.¹

¹ In the Matter of the Z Trusts [2015] JRC 196.

The first principle is the 'cash flow' test, which should be applied in order to establish whether or not a trust is insolvent. The question to be answered is - do the trustees have sufficient liquid assets available in order to cover the immediate financial liabilities? If they do not, then the trust is considered to be insolvent.

As you will have understood, this cash-flow test is similar to the test applied in respect of companies and individuals who are facing financial difficulties.

The second principle is if the trust fails the cash flow test then the trustees are no longer required to act for the benefit of the beneficiaries, but rather must act in the interests of all the creditors, as a class. This may of course lead to decisions that the beneficiaries do not agree with, however, the Court has confirmed that their claims are outweighed by the established claims of the creditors.

Summary

It is crucial that trustees are skilled at navigating the financial affairs of a trust to ensure that financial obligations can be satisfied as they fall due.

If a trustee considers that a trust may be 'insolvent', meaning it fails to satisfy the cash flow test, then the trustee would be well advised to work with all the creditors, exercising their powers fairly and with the support of such creditors or failing which in accordance with directions provided by the Court.

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